

Regulatory Alert

Regulatory Insights for Financial Services

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SEC Private Fund Adviser Reforms: Final Rules

KPMG Insights:

- *The SEC's new rules and rule amendments expand regulation requirements for private fund advisers.*
- *In final form, however, the provisions include modifications from the proposal that provide advisers with some flexibility, such as:*
 - *The ability to now choose between a fairness opinion and a valuation opinion for advisor-led secondary transactions*
 - *The ability to engage in activities they may not otherwise engage in (e.g., certain fees, expenses, clawbacks) provided they make certain disclosures or obtain investor consent.*
- *The new requirements will improve investors' ability to monitor the costs and performance of their fund investments, including compensation, fees, and expenses, and to more easily make comparisons between prospective investments.*

The Securities and Exchange Commission (SEC) has adopted [final rules and amendments](#) under the Investment Advisers Act of 1940 (Advisers Act) that enhance regulation of private fund advisers with the goal of protecting investors. The SEC states the rules are designed to address three factors for risks and harms in an adviser's relationship with private funds and their investors: "lack of transparency, conflicts of interest, and lack of effective governance mechanisms for client disclosure, consent, and oversight."

The SEC highlights several "key changes" from the proposal (see KPMG Regulatory Alert, [here](#)) including:

- A change in scope, such that the five new rules adopted will not apply to investment advisers with respect to securitized asset funds they advise.
- A ten-year lookback for certain liquid fund performance metrics rather than measuring such performance since inception under the Quarterly Statement Rule, as well as additional time for delivery of the fourth quarter statements.

- An option for advisers to choose between a fairness opinion or a valuation opinion under the Advisor-Led Secondaries Rule.
- Permission for an adviser to engage in certain activities if they provide certain disclosures or, in some cases, investor consent (under the Restricted Activities Rule, which has been renamed from the proposed Prohibited Activities Rule).
- Adoption of "legacy status" under the Restricted Activities Rule and the Preferential Treatment Rule for certain governing agreements.

The final rules and amendments are highlighted below. Changes from the proposal are denoted in italics.

Quarterly Statements, Independent Audits, and Fairness Opinions. The rules will require registered private fund advisers (or advisers required to be registered) to:

<p>Quarterly Statement Rule</p>	<p>Prepare and distribute quarterly statements for each private fund that they advise to the fund’s investors covering fund-level information, including fees, expenses, performance, and adviser compensation within forty-five (45) days after the first three fiscal quarter ends, <i>and ninety (90) days after the fiscal year end (for a private fund that is a fund of funds, the quarterly statement must be distributed within seventy-five (75) days after the first three fiscal quarter ends, and one hundred twenty (120) days after the fiscal year end)</i>. As part of the quarterly statement:</p> <ul style="list-style-type: none"> — Disclosures must be presented in table format at both the fund- and portfolio investment-levels (defined as “any entity or issuer in which the private fund has invested directly or indirectly”). <i>In a change from the proposal, SEC did not adopt the requirement that advisers disclose the private fund’s ownership percentage of each covered portfolio investment.</i> — Fees and expenses must include all compensation paid during the reporting period to the private fund adviser and “related persons” (as defined in the rule). — Performance information must be presented in a standardized format where: <ul style="list-style-type: none"> - Liquid fund performance is based on net total return on an annual basis for the shorter of <i>ten (10) fiscal years</i> prior to the quarterly statement or since the fund’s inception, as well as over one-, five-, and ten-year periods, and on a cumulative basis for the current year. - Illiquid fund performance is based on the internal rate of return and a multiple of invested capital since inception, as well as a statement of contributions and distributions.
<p>Private Fund Audit Rule</p>	<p>Obtain an annual independent financial statement audit of each private fund they advise that <i>meets the requirements of the audit provision in the Advisers Act Custody Rule (Rule 206(4)-2)</i>), including:</p> <ul style="list-style-type: none"> — The audit must be performed by an independent public accountant that meets SEC standards of independence and is registered with, and subject to review by, the Public Company Accounting Oversight Board (PCAOB). — The audit must be performed under PCAOB or AICPA auditing standards. — Audited financial statement must be prepared in accordance with generally accepted accounting principles (US GAAP). — Annually within 120 days of the private fund’s fiscal year-end and “promptly” upon liquidation, the private fund’s audited financial statements are delivered to investors in the private fund. For private funds that are funds of funds a 180-day time period applies.
<p>Adviser-Led Secondaries Rule</p>	<ul style="list-style-type: none"> — Obtain and distribute a <i>fairness or valuation opinion</i> from an independent opinion provider (prior to due date of the election form) in connection with certain adviser-led secondary transactions where an adviser offers fund investors the option to sell their interests in the private fund, or to exchange them for new interests in another vehicle advised by the adviser. — Prepare and distribute to private fund investors a written summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider.

Restricted Activities and Preferential Treatment. Additionally, the final rules adopt provisions for all private fund advisers (regardless of registration status) that may restrict certain activities and practices the SEC states have the potential to lead to investor harms:

<p>Restricted Activities Rule</p>	<p>In a change from the proposal, the final rule restricts private fund advisers from engaging in the following activities <i>unless they satisfy certain disclosure and, in some cases, consent requirements</i>:</p> <ul style="list-style-type: none"> — Charging or allocating fees or expenses to the private fund associated with investigations of the adviser or its related persons by any governmental or regulatory authority. Furthermore, regardless of any disclosure or consent, an adviser may not charge or allocate fees and expenses related to investigations that result or have resulted in a court or governmental authority imposing a sanction for violating the Advisers Act or related rules. — Charging the private fund for any regulatory, examination, or compliance fees or expenses of the adviser or its related persons. — Reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders. <ul style="list-style-type: none"> - Charging or allocating fees and expenses related to a portfolio investment on a non-pro rata basis when more than one private fund or other client advised by the adviser or its related persons have invested in the same portfolio company. - Borrowing money, securities, or other private fund assets, or receiving a loan or extension of credit, from a private fund client. <p>The SEC did not adopt the proposed provisions related to fees for unperformed services or indemnification.</p>
<p>Preferential Treatment Rule</p>	<p>Under the final rule, advisers may not provide preferential treatment to an investor if the adviser reasonably expects the preferential terms would have a material, negative effect on other investors, specifically with respect to:</p> <ul style="list-style-type: none"> — Redemptions from the fund, unless the ability to redeem is legally required or the adviser offers the preferential redemption rights to all other investors without qualification. — Information about portfolio holdings or exposures, unless such preferential information is offered to all investors at the same time or “substantially” the same time. <p>In addition, an adviser may not provide any preferential treatment for any investor unless the adviser provides written notices disclosing i) <i>certain preferential terms to prospective investors</i> prior to the investor’s investment in the private fund, and ii) at least annually, all preferential terms provided to investors in the same private fund, regardless of whether the fund is liquid or illiquid.</p>
<p>Adviser Misconduct</p>	<p>SEC did not adopt provisions from the proposal related to adviser misconduct regarding:</p> <ul style="list-style-type: none"> — Charging a portfolio investment fees for unperformed services. — Seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness.

Books and Records Rule Amendments. The SEC also adopted amendments to the Advisers Act “books and records rule” that require advisers to private funds that are registered or required to be registered to retain books and records related to the requirements for the Quarterly Statement Rule, Annual Audit Rule, Adviser-Led Secondaries Rule, the Preferential Treatment Rule and the Restricted Activities Rule.

Compliance Rule Amendments. For all registered advisers, including those that do not advise private funds, the final rule amends the Adviser Act “compliance rule” to require the advisers to document in writing the required annual review of the adequacy of compliance policies and procedures and the effectiveness of their implementation.

Compliance Dates. The final rules and amendments provide for the following compliance dates:

- Compliance with the Quarterly Statement and Audit Rules will be required eighteen (18) months after publication in the Federal Register for all private fund advisers.
- Compliance with the Adviser-Led Secondaries, Preferential Treatment, and Restricted Activities Rules will vary based on an adviser’s assets under management (AUM):
 - Advisers with \$1.5 billion or more in AUM (“larger” private fund advisers) will be required to comply with

the rules twelve (12) months after publication in the Federal Register.

- Advisers with less than \$1.5 billion in AUM (“smaller” private fund advisers) will be required to comply with the rules eighteen (18) months after publication in the Federal Register.
- Compliance with the amended Advisers Act compliance rule will be required for all advisers sixty (60) days after publication in the Federal Register.

Legacy Status. The SEC will provide a “legacy” status for aspects of the Preferential Treatment Rule (which restricts advisers’ ability to provide certain preferential redemption rights and information about portfolio holdings) and the aspects of the Restricted Activities Rule that require investor consent (which restrict an adviser from borrowing from a private fund and from charging for certain investigation fees and expenses). The legacy status applies to governing agreements that were entered into prior to the compliance date if compliance with the rules would require parties to amend the agreement by private funds that had commenced operations as of the compliance date.

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